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TREASURY FO A/S LOWERY, MARK SOBEL, BILL MURDEN, ERIC MEYER
SENSITIVE BUT UNCLASSIFIED - ENTIRE TEXT

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TAGS: ECON EFIN EINV EUN
SUBJECT: TREASURY AND COMMISSION ASSESS FINANCIAL MARKET TURMOIL

¶1. SUMMARY. A Treasury team led by DAS Mark Sobel met on January 8 in Brussels with European Commission officials and private sector representatives separately to discuss global financial market turmoil, including the impact on the real economy and regulatory policy implications. The officials told Treasury they expect repricing of risk and credit tightening to continue for some time as banks continue to disclose subprime mortgage-related losses. The officials' worst case EU forecast from 2007 has become their baseline, but they believe they have incorporated most downside risks, noting that much of the EU economy remains strong and that they expect EU growth to slow only slightly. High oil prices may have a greater economic impact than financial turmoil due to its quick pass-through to consumers. They believe the U.S. will enter a low-growth "soft spot" for several quarters. Both sides thought securitization activity may pull back in the future. The Commission is working to fulfill October 2007 Council mandates to review transparency, asset valuation and the prudential financial supervision framework in considering long-term responses to the crisis. The goal is to deliver a package or proposals to the spring European Council meeting on March 13-14. The Treasury team also exchanged views with private sector representatives on the turmoil.
END SUMMARY.

ASSESSING GLOBAL FINANCIAL MARKET TURMOIL

¶2. Mark Sobel, Treasury DAS for International Financial Issues, and Bill Murden, Director of Treasury's Office on International Banking and Securities Markets, met with officials from the European Commission's Internal Markets (DG MARKT) and Economic and Monetary Affairs (DG ECFIN) Directorates January 8 to assess global

financial
market turmoil, examine its real economy impacts and discuss
its
regulatory implications. They were accompanied by Barbara C.
Matthews, USEU Treasury Financial Attach, Lukas Kohler from
Treasury's Europe Office and Econoff. The Commission fielded
a team
of 10, led by Elemer Tertak, DG MARKT Director for Financial
Institutions, Pierre Delsaux, DG MARKT Director for Free
Movement of
Capital, Company Law and Corporate Governance, and Servaas
DeRoose,
DG ECFIN Director for Macroeconomy of the Euro Area and EMU.

COMMISSION: FINANCIAL MARKET TURMOIL, AND ITS
REAL ECONOMY IMPACTS, LIKELY TO CONTINUE

¶3. Sobel opened by seeking EU views on the subprime
mortgage-related financial market situation. DeRoose
explained that
the turmoil will continue to affect EU economies through three
channels: a) impact on the U.S. economy (slow growth expected
for
the first quarters this year); b) decreased bank lending; and
c)
decreased consumer and commercial confidence.

¶4. The recent oil price shock, DeRoose continued, may hurt EU
economies more than the financial markets crisis. The
Commission
still projects EU growth above two percent for 2008, although
if oil
prices stay near the current $95/barrel growth will drop.
John

Berrigan of ECFIN explained that the Commission's 2007 worst
case
forecast has now become the baseline scenario for 2008.
Repricing
of risk and tightening of credit will continue well into the
year,
he added, with less lending overall. Tertak of DG MARKT
noted that
the housing and construction slowdown in some Member States
(e.g.
Spain) could adversely impact consumer behavior and GDP. The
officials said they project an EU recovery to near potential
growth
(e.g. 2.2 percent/year) in 2009.

¶5. Sobel responded by underscoring messages from Treasury
Secretary

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Paulson's recent speeches. On the negative side, the U.S.
housing
situation will impose a penalty on U.S. growth, and it is
unclear
how long this will last; recent job growth numbers were low;
consumption and other consumer data are mixed. On the plus
side,
the current account is adjusting, the fiscal deficit has
dropped to
1.2 percent of GDP, and banks are mobilizing capital. In
sum, Sobel
said, the U.S. prognosis appears to be for very slow growth
in the
first half of 2008.

¶6. Berrigan of ECFIN noted that the crisis has damaged the
"originate and distribute" model of securitization. (Note:
This
model has produced new complex financial products, including
repackaged and resold mortgages, which disperse risk. Many

of these
assets are held "off-balance-sheet" by financial
institutions. In
the U.S., defaults on securitized subprime loans have been a
prime
factor in the current crisis, producing losses for banks which
bought the loans. End note). Sobel said that upcoming
Financial
Stability Forum (FSF) consideration of these issues should be
useful.

SOVEREIGN WEALTH DEVELOPMENTS

¶7. Tertak asked about current U.S. sentiment toward Sovereign
Wealth Fund (SWF) investment. Sobel noted that the USG is
actively
engaged on CFIUS. He said that the G7 has asked the IMF to
develop
best practices on SWFs, looking at issues such as SWF
transparency
and governance. The USG had also encouraged the OECD to
examine best
practices for recipients on investment. This was all part of
an
effort to promote the openness of global financial flows.
He added
that observers recognized that recent high-profile SWF
investments
in Citibank and Morgan Stanley provided these institutions
with
needed capital. He recommended that EC officials look at the
article Deputy Secretary Kimmitt had recently published in
Foreign
Affairs discussing related policy issues. Tertak responded
that he
had seen the article already.

EU REGULATORY POLICY RESPONSE BEING FORMULATED

¶8. Sobel and Murden asked the Commission to provide insight
into
the EU's plan for addressing the regulatory issues raised by
the
financial market crisis. Delsaux of DG MARKT emphasized that
since
the "crisis" is still underway, it is too early to draw firm

conclusions, particularly on asset valuation. The Commission
is
examining potential regulatory steps, he said, for action
later. He
noted that the Commission supports the FSF's work on valuation
currently underway.

¶9. Giuseppi Siani, of DG MARKT, offered more details. He
noted
that the Commission is working to fulfill October 2007
European
Council mandates to review transparency, asset valuation and
the
prudential financial supervision framework in response to the
crisis. The Commission, Siani said, seeks to enhance
transparency
by developing a common database or portal for securitized and
other
assets. They are working with the European industry
(particularly
the European Securitization Forum) to design the portal and
the
categorization of counterparties and assets at an
appropriately
aggregated level. Their goal is to increase transparency to
market

participants as well as to provide greater insight into risk
exposures across a broad range of counterparties in the
financial
system.

¶10. Commission officials asked whether U.S. regulatory
agencies
(e.g., the SEC or the Federal Reserve) have or seek access to
similar data. Murden responded that if anyone had the data
it would
be the Federal Reserve and recommended that the Commission
speak
with them.

¶11. In addition, the Commission wants to ensure consistent
application of valuation standards, although the officials
did not
specify which particular projects are aimed at achieving this
goal.
Finally, they are working with the Basel Committee to consider
potential revisions to the Basel II regulatory framework in
light of
the crisis.

¶12. DG MARKT officials emphasized that many streams of work
underway predate the emergence of the crisis. They noted
that there
are 33 total initiatives in three general areas: a) credit
markets;
b) a general financial crisis management inside the EU; and c)
reviewing the Lamfalussy framework to assess whether further
adjustments in authorities and working arrangements among EU
regulatory officials are needed. Treasury Financial Attach
asked
about the mood in the European Parliament toward these
initiatives.
Delsaux said the Parliament has been relatively silent on many
questions, including the accounting and asset valuation work
streams.

¶13. DG MARKT officials said their short term goal is to
prepare a
package of proposals for approval by the Economic and
Financial
Council of finance ministers (ECOFIN) in February and then
presented
to the Spring European Council (of EU heads of state) March
13-14.
Tertak noted that the Commission wants quick progress, he
said, but
not at any price, and seeks to proceed at a measured pace in
developing responses.

¶14. Murden explained that the US President's Working Group
is also
assessing potential responses to the crisis. He noted, for
example,
that the SEC is reviewing the role of credit rating agencies.
Murden also mentioned that the Federal Reserve issued a

proposal in
December to tighten underwriting standards and address
predatory
lending practices.

SEEKING PRIVATE SECTOR VIEWS ON FINANCIAL TURMOIL
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¶15. The Treasury team concluded its short visit to Brussels
with a
private industry roundtable on EU regulatory and financial
policy
coordination. DAS Sobel and Murden heard from several banks
that
implementation of the Markets in Financial Instruments

Directive
(MIFID) is going well across the EU, that the EU banking
system has
shown resilience during the financial crisis, and that banks
hope
regulatory responses to the crisis do not restrain financial
sector
development.

¶16. Banks from Spain and Germany expressed contradictory
views on
the treatment of asset valuation issues in the context of the
crisis. Some expressed concern with the activist nature of
the
European Commission's efforts, but many also expressed relief
that
the Commission was working with the industry rather than
trying to
address the issues by itself. One participant expressed
interest in
the U.S.-EU Transatlantic Economic Council (TEC), but did not
make
specific recommendations.

¶17. Treasury DAS Sobel has cleared this cable.

MURRAY